Striking down class-action waivers in arbitration: Freedom of contract vs. fairness of contract

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Determining the enforceability of mandatory class-action waiver provisions in arbitration clauses is not merely an academic exercise for those sheltered within ivory tower walls. Indeed, a number of important legal and public policy implications underlie such a determination. In a recent decision, *In re American Express Merchants Litigation*, the 2nd U.S. Circuit Court of Appeals rendered a class-action waiver provision in the mandatory arbitration clause of a commercial contract between a charge card carrier and its merchants unenforceable.[1]

Reaffirming its earlier decision, upon remand from the U.S. Supreme Court for supplemental briefing, the 2nd Circuit reasoned that because of the prohibitive costs of arbitrating the antitrust claims individually, as demonstrated by a detailed cost analysis in the plaintiffs' expert affidavit, "enforcement of the clause would effectively preclude any action seeking to vindicate the statutory rights asserted by the plaintiffs."[2]

Under the rule established by *In re Amex*, class-action waivers in arbitration agreements are unenforceable if the costs of arbitration by individual plaintiffs would be so high as to outweigh the size of any possible recovery.

FACTS AND PROCEDURAL HISTORY

The plaintiffs, California and New York merchants operating businesses that have contracted with American Express, filed a class-action complaint against Amex in the U.S. District Court for the Southern District of New York. They accused Amex of violating the Sherman Antitrust Act, 15 U.S.C. § 1, by "tying" various products in such a way that the merchants were forced to accept Amex charge, credit and debit cards. The plaintiffs sought to represent a class consisting of all merchants that have accepted Amex charge cards — and therefore been forced to accept other cards issued by Amex.

Amex moved to compel arbitration in the District Court under the terms of its contracts with the plaintiffs. The court granted that motion and dismissed the plaintiffs' case. It rejected the merchants' argument that the class-action waiver in the contract's mandatory arbitration provision effectively prevented them from asserting their statutory rights since the cost of pursuing each claim individually would be prohibitively high.[3]

The court instead held that the question of whether the class-action waiver was enforceable was one left for the arbitrators — and not the court — to resolve. The court also determined that the plaintiffs could recover treble damages under the Clayton Act, 15 U.S.C. § 12, through the arbitration proceeding.

On appeal, the 2nd Circuit *twice* overturned the District Court's decision.

> The *Amex* court said "class-action waivers ... are unenforceable if the costs of arbitration by individual plaintiffs would be so high as to outweigh the size of any possible recovery."

It first held that the enforceability of a class-action waiver provision is a question of law for the courts, not for the arbitrators. The 2nd Circuit did not find controlling the Supreme Court's decision in *Gilmer v. Interstate/Johnson Lane Corp.* that arbitration clauses are enforceable absent a clear showing that Congress had intended to preclude a waiver of judicial remedies.[4]

Gilmer involved the application of a mandatory arbitration rule of the New York Stock Exchange to a lawsuit brought by a brokerage firm manager under the Age Discrimination in Employment Act. The Supreme Court rejected the petitioner's argument that the arbitration procedures in the NYSE's rules did not promote the ADEA's purpose, which expressly permits class actions, because those rules prohibited class-action arbitration.

The 2nd Circuit panel at the time, which included current Supreme Court Justice Sonia Sotomayor, distinguished the *Gilmer* decision. That panel noted that unlike the petitioner in *Gilmer*, the plaintiffs in *In re Amex* were not claiming that the class waiver was void merely because the antitrust laws permit class actions.

Instead, the panel determined that a more nuanced question was before the court: "whether the mandatory class-action waiver ... is enforceable even if the plaintiffs are able to demonstrate that the practical effect of enforcement of the waiver would be to preclude their bringing Sherman Act claims against Amex in either an individual or collective capacity."[5]

The panel found that the Supreme Court's decision in *Green Tree Financial Corp.-Alabama v. Randolph* answered this question.

In *Randolph*, the high court addressed the question of whether "an arbitration agreement that does not mention arbitration costs and fees is unenforceable because it fails to affirmatively protect a party from potentially steep arbitration costs."[6]

There, the Supreme Court held that "a party seek[ing] to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive ... bears the burden of showing the likelihood of incurring such costs."[7] The *Randolph* court ultimately upheld the arbitration agreement because it found that the plaintiff had failed to make the required showing.

Although *Randolph* did not directly consider the effects of its holding on arbitration agreements that preclude class actions, several circuit courts have used the decision to uphold arbitration agreements that ban class actions, basing their rulings on

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the plaintiffs' failure to present sufficient evidence of prohibitive costs.

Applying *Randolph*, the 2nd Circuit panel concluded that the plaintiffs had demonstrated the prohibitive costs of individual arbitration of their claims, noting that the record "abundantly" supported their argument that they would face such prohibitive costs if they were forced to arbitrate each claim separately.[8]

> The 2nd Circuit found that *Stolt-Nielsen* does not render contractual clauses barring class arbitration per se enforceable.

The *Amex* court relied on a "compelling" affidavit from the plaintiffs' expert. This affidavit explained that the out-of-pocket costs of pursuing an antitrust case would be at least several hundred thousand dollars, but that the median amount any plaintiff can expect to recover is $5,000 in damages.[9]

In addition, under the fee-shifting rules for federal antitrust cases, a prevailing plaintiff would be reimbursed at most $40 per day for its expert witness expenses. This is just a fraction of the actual costs related to a complex antitrust matter.

Consequently, the 2nd Circuit ruled in the plaintiffs' favor, finding that *if* the arbitration clause were enforced, it would deprive the plaintiffs of the statutory protections afforded by antitrust laws. The class waiver provision therefore acted as a waiver of future liability under the federal antitrust statutes and was thus void as a matter of public policy.

The court added, however, that class-action waivers in arbitration agreements are not per se unenforceable (instead requiring a case-by-case analysis based on the particular circumstances) and that it did not limit its decision to plaintiffs who are "small merchants."

In May 2010 the Supreme Court vacated the first *In re Amex* decision and remanded the case for reconsideration in light of its ruling in *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*[10] Upon reconsideration and review of supplemental briefs, the 2nd Circuit reaffirmed its prior decision.

POLICY IMPLICATIONS AND THE ECHOES OF SUBSTANTIVE DUE PROCESS

The 2nd Circuit rejected appellee Amex's reliance on *Stolt-Nielsen.* That case, Amex had argued, compels the court to "expressly reject[] the use of public policy as a basis for finding contractual language void"[11] and to fulfill its "obligation to faithfully *enforce* (not just construe) the parties' arbitration agreement."[12]

Stolt-Nielsen involved a challenge to an arbitration award in a dispute between shipping companies and their customers in which both parties stipulated that the contract's arbitration clause was silent on the issue of class arbitration. In an opinion written by Justice Samuel Alito, a divided Supreme Court found that there was no contractual basis for the arbitration panel's conclusion that both parties had agreed to submit to class arbitration.[13]

In rejecting Amex's argument, the 2nd Circuit found that *Stolt-Nielsen* does not render contractual clauses barring class arbitration per se enforceable. Distinguishing the two cases, the court said *In re Amex* does not answer the question of whether the plaintiffs' contract provides for class arbitration, but instead focuses on "whether the class-action waiver is enforceable when it would effectively strip plaintiffs of their ability to prosecute alleged antitrust violations."[14]

To further distinguish the two cases, the *Amex* court found that "[w]hile *Stolt-Nielsen* plainly rejects using public policy as a means for divining the parties' intent, nothing in *Stolt-Nielsen* bars a court from using public policy to find contractual language void."[15]

The court agreed with the merchants' argument that "[t]o infer from *Stolt-Nielsen*'s narrow ruling on contractual construction that the Supreme Court meant to imply that an arbitration is valid and enforceable where, as a demonstrated factual matter, it prevents the effective vindication of federal rights would be to presume that the *Stolt-Nielsen* court meant to overrule or drastically limit its prior precedent."[16]

Indeed, the *Amex* court proceeds to highlight the recognized importance of the class-action mechanism in vindicating rights that could not otherwise be protected through piecemeal litigation, noting that:

> Class-action lawsuits are well recognized by the Supreme Court as a vehicle for vindicating statutory rights. This is especially true with respect to the court's recognition that the class-action device is the only economically rational alternative when a large group of individuals or entities has suffered an alleged wrong, but the damages due to any single individual or entity are too small to justify bringing an individual action.[17]

The 2nd Circuit's decision in *In re Amex* reflects courts' continued recognition that the public policy of using the class-action mechanism as a vehicle to vindicate statutory rights trumps potentially overriding concerns about the freedom of contract.

This notion, that "[t]he policy at the very core of the class-action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights," is now a firmly rooted part of our judicial canon.[18]

Oftentimes, "[e]conomic reality," including gross disparities in the parties' bargaining power or degree of access to the courts,

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"dictates that [a] petitioner's suit proceed as a class action or not at all."[19] The existence of and opportunity to resort to the class-action mechanism "may motivate [plaintiffs] to bring cases that for economic reasons might not be brought otherwise [, thereby] vindicating the rights of individuals who otherwise might not consider it worth the candle to embark on litigation in which the optimum result might be more than consumed by the cost."[20]

As the 7th Circuit aptly noted in one such case, "the realistic alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for $30."[21]

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In recognizing the public policy importance of the class-action mechanism and rejecting contractual clauses that undermine a party's ability to collectivize litigation, courts are perhaps drawing a veiled analogy to early 20th-century cases — and their progeny — that established the basis for upholding certain substantive due process rights at some expense to the freedom of contract.[22]

Years from now, *In re Amex* may be viewed in hindsight as an extension of the long line of cases in our substantive due process jurisprudence, notably *United States v. Carolene Products,* that embrace the ability for "discrete and insular minorities"[23] and members of other protected classes to vindicate enumerated statutory rights through the judicial system — however small or inconsequential the potential payoff — as a fundamental right "implicit in the concept of ordered liberty."[24]

Although more than three-quarters of a century apart, *In re Amex* and *Carolene Products* may be inexorably intertwined as threads in the development and evolution of our post-modern conception of substantive due process. WJ

NOTES

1 634 F.3d 187 (2d Cir. 2011).

2 *Id.* at 189.

3 *In re Am. Express Merchants Litig.,* No. 03-cv-9592, 2006 WL 662341 (S.D.N.Y. Mar. 16, 2006).

4 500 U.S. 20 (1991).

5 *In re Am. Express,* 554 F.3d 300, 314 (2d Cir. 2009).

6 531 U.S. 79. 82 (2000).

7 *Id.* at 92.

8 *In re Am. Express,* 554 F.3d at 315.

9 *Id.* at 316-17.

10 130 S. Ct. 1758 (2010).

11 In re Am. Express, 634 F.3d at 199.

12 *Id.* at 193 (citing Amex Supp. Reply Br. at 1) (emphasis in the original).

13 *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.,* 130 S. Ct. at 1775-76.

14 *In re Am. Express Merchants Litig.,* 634 F.3d at 193-94.

15 *Id.* at 199.

16 *Id.* (citing plaintiffs' Supp. Brief at 7).

17 *Id.* at 194.

18 *Id.* (quoting *Amchem Prods. v. Windsor,* 521 U.S. 591, 617 (1997)); *see also Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997).

19 *Eisen v. Carlisle & Jacquelin,* 417 U.S. 156, 161 (1974).

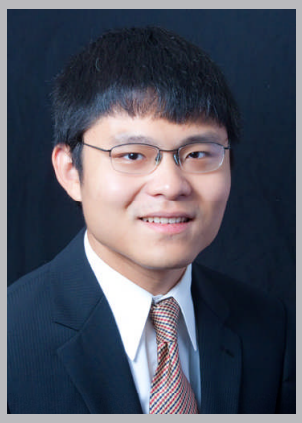
20 *Deposit Guar. Nat'l Bank v. Roper,* 445 U.S. 326, 338 (1980).

21 *Carnegie v. Household Int'l,* 376 F.3d 656, 661 (7th Cir. 2004).

22 *See, e.g., Lochner v. New York,* 198 U.S. 45 (1905). *See also* U.S. CONST. amend. XIV, sec. 1.

23 *United States v. Carolene Prods. Co.,* 304 U.S. 144, 155 at n. 4 (1938).

24 *Palko v. Connecticut,* 302 U.S. 319, 324-25 (1937).



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